

United States
Circuit Court of Appeals
For the Ninth Circuit.

—
FONTANA POWER COMPANY, a corporation,
Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

—
Transcript of the Record

—
Upon Petition to Review a Decision of the United States
Board of Tax Appeals.

FILED

OGT - 4 1941

PAUL P. O'BRIEN

CLERK

United States
Circuit Court of Appeals
for the Ninth Circuit.

FONTANA POWER COMPANY, a corporation,
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[Clerk's Note: When deemed likely to be of an important nature, errors or doubtful matters appearing in the original certified record are printed literally in italic; and, likewise, cancelled matter appearing in the original certified record is printed and cancelled herein accordingly. When possible, an omission from the text is indicated by printing in italic the two words between which the omission seems to occur.]

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United States Circuit Court of Appeals
For the Ninth Circuit

BTA No. 99767

FONTANA POWER COMPANY,

Appellant,

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

AGREED STATEMENT OF CASE ON APPEAL

Pursuant to Rule 76 of the Rules of Civil Procedure for the District Courts of the United States, the parties, by their respective counsel, make and sign this Statement of Case, as follows:

1. Prior to March 21, 1941, there was pending before the United States Board of Tax Appeals (hereinafter called "Board") a proceeding in which Fontana Power Company, a corporation (appellant above named), was petitioner and Commissioner of Internal Revenue (appellee above named) was respondent. The Commissioner determined a deficiency in income taxes and excess profits taxes of appellant for the years of 1935, 1936 and 1937. In making such determination, the Commissioner disallowed as deductions, payments made by appellant to Fontana Union Water Company, during said years, pursuant to a contract in writing of which a copy is hereinafter set forth. (Exhibit 5 hereof.) [1*] In said

*Page numbering appearing at foot of page of original certified
Transcript of Record.

proceeding, the Commissioner contended such payments were not allowable as deductions under the Internal Revenue Code and appellant claimed said payments were allowable deductions (a) as interest and (b) as ordinary and necessary expenses of appellant's business.

On March 21, 1941, the United States Board of Tax Appeals promulgated its findings of facts and opinion in which the contentions of the respondent on review were sustained and the contentions of the petitioner on review disallowed; and on March 29, 1941, the Board entered its decision redetermining the tax liability in accordance with its opinion and findings of fact. Attached hereto and made a part hereof are copies of such opinion and findings of fact and decision of the Board, being marked Exhibits 1 and 1A.

2. Said decision was rendered on March 29, 1941, and within three months thereafter, appellant filed with said Board a petition for review of said decision by the above entitled Court. A copy of said petition for review is attached as Exhibit 2 hereto.

3. The facts found or stated in the findings of fact of said Board (which findings are set forth in Exhibit 1) are hereby adopted and made a part of this Statement of Case as fully as though here repeated, provided any fact or statement in said findings in conflict with any fact or statement appearing from or in any other instrument incorporated in this Statement, or in conflict with any fact or statement hereinafter contained, shall give way to and

be controlled by the fact or statement in such other instrument or hereinafter contained. [2]

4. Attached, and by reference incorporated herein, are copies of instruments (or portions of instruments) referred to in said findings, as follows:

(a) Supplemental Application to the Railroad Commission of California filed prior to October 10, 1916, as Exhibit 3 hereof. This application was executed and verified by each of Fontana Power Company, Fontana Company and Fontana Union Water Company. The caption, signatures and affidavits are omitted from the copy;

(b) Decision No. 3773 of Railroad Commission rendered October 10, 1916, as Exhibit 4 hereto. Omitted from the copy are the caption and all parts other than those portions directly referring to the contract involved in this proceeding;

(c) Contract entered into on June 15, 1917 (but dated January 30, 1917), pursuant to which the payments involved in this proceeding were made, as Exhibit 5 hereto;

(d) Third Supplemental Order of said Railroad Commission, dated June 6, 1917, as Exhibit 6 hereto.

5. The contract (Exhibit 5) was executed pursuant to authorization contained in said Decision 3773 of the Railroad Commission (Exhibit 4) and in said Third Supplemental order (Exhibit 6).

6. The bonds issued by appellant referred to in said findings were serial bonds maturing annually from December 1, 1921 to December 1, 1946, inclusive.

7. The amount of income on which said taxes were [3] assessed, the amount in dispute, and the amount not in dispute, for each year involved in said proceeding are as stated in the following tabulation:

| | Amount of income not in dispute. | Amount of income in dispute | Amount of income on which taxes were assessed |
|-----------|-------------------------------------|--------------------------------|---|
| 1935..... | \$ 6,930.17 | \$18,262.39 | \$25,192.56 |
| 1936..... | 1,919.93 | 16,244.55 | 18,164.48 |
| 1937..... | 15,114.98 | 27,000.00 | 42,114.98 |

The amount of income in dispute for any year corresponds with the payments made that year by appellant to Fontana Union Water Company, under paragraph 4 of said contract (Exhibit 5), which payments the Board held were not allowable as deductions.

8. The points relied on by appellant on appeal are:

(a) Said decision is contrary to law in that thereby income taxes and excess profits taxes for the years 1935, 1936 and 1937 are imposed upon amounts in excess of appellant's net taxable income for said years, respectively, such excessive amounts corresponding with and being equal to payments made by appellant to Fontana Union Water Company, as follows:

For 1935, the sum of \$18,262.39;

For 1936, the sum of \$16,244.55;

For 1937, the sum of \$27,000.00;

(b) Said Board erred in holding that said payments of \$18,262.39, \$16,244.55 and \$27,000.00 were

not deductible from appellant's gross income for the respective years paid; [4]

(c) Said Board erred in holding said payments were distributions in the nature of dividends;

(d) Said Board erred in holding said payments were not interest;

(e) Said Board erred in holding said payments were not ordinary and necessary business expenses.

GEO. W. HELLYER,

JOHN B. SURN,

Counsel for Appellant.

J. P. WENCHEL,

Counsel for Appellee.

Approved and ordered Filed:

JOHN W. KERN

Board Member. [5]

EXHIBIT 1

United States Board of Tax Appeals

Docket No. 99767.

Promulgated March 21, 1941.

FONTANA POWER CO.,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

Petitioner was incorporated in 1916, all of its capital stock (except for qualifying shares) being

issued to the Fontana Co. and the Fontana Water Co., from which companies it acquired title to property necessary to the operation of its business. By contract it agreed to pay these companies an amount equal to the difference between the value of the stock and the value of the property, to be later determined, and pending such determination to pay to them all of its net profits. Later the Fontana Water Co. acquired from the Fontana Co. all of its stock and rights under this contract. The value of the property was never determined and the petitioner has continued to pay to the Water Co. all of its net profits. Held, that such payments during taxable years of 1935, 1936, and 1937 were distributions in the nature of dividends.

George Hellyer, Esq., and James W. Bontems, C. P. A., for the petitioner.

Samuel Taylor, Esq., for the respondent.

This proceeding involves income and excess profits tax liability for the years 1935, 1936, and 1937. The Commissioner determined deficiencies in income tax in the amounts of \$2,536.66, \$1,758.22, and \$3,130.50, respectively, for those years; and deficiencies in excess profits tax in the amount of \$922.42, \$189.87, and \$2,787.58, respectively. The petitioner seeks a redetermination of those deficiencies. The question presented is whether petitioner may deduct from its gross income certain payments made by it to its sole stockholder, which amounts petitioner asserts were payments of interest and respondent asserts were distributions in the nature of dividends.

FINDINGS OF FACT.

The parties have fully stipulated the facts in this proceeding, and, as stipulated, we have adopted those facts, which are materially as follows:

The Fontana Power Co., petitioner herein, was incorporated under the laws of the State of California on or about April 3, 1916, [6] and at all times since has functioned as a public utility corporation, subject to the jurisdiction of and regulation by the Railroad Commission of the State of California. Its principal place of business is at Fontana, California.

The Fontana Union Water Co., hereinafter called the Water Co., was incorporated in 1912 under the laws of the State of California as a mutual water company for the irrigation of farm lands in the vicinity of the town of Fontana. The Water Co. has been held by the Bureau of Internal Revenue to be exempt under section 101 of the Revenue Acts of 1934 and 1936 from income and capital stock taxation.

The Fontana Co. was incorporated under California law prior to petitioner, and continued to be so incorporated until it was dissolved in 1927.

A. B. Miller was president of all three corporations.

Prior to August 9, 1916, the petitioner made application to the Railroad Commission of California for a certificate that public convenience and necessity require the construction of an electrical power plant and system near the town of Rialto; and for

leave, *inter alia*, to execute a mortgage on its properties and to issue thereunder \$350,000 face value of first mortgage 6 percent bonds, and for leave to acquire from the Water Co. and the Fontana Co. certain properties and property rights. Thereafter, prior to October 10, 1916, petitioner filed with the commission a supplemental application reciting that it appeared impossible at that time to prepare and submit to the commission data sufficient to enable the commission to fix the value and approve the purchase price of the properties proposed to be conveyed by the Water Co. and the Fontana Co. to petitioner. The application stated that petitioner had an option to purchase certain steel required for use in construction of its proposed pressure pipes, which option would expire October 6, 1916, after which time the price of steel would be considerably higher due to the wartime market. In order to prevent the loss of this steel contract and allow further time in which to prepare data for the commission respecting the fixing of the value and approval of the purchase price of the properties, it was proposed to enter into an agreement providing for the immediate conveyance of the properties to petitioner for the consideration of: (1) 100 shares of capital stock in the petitioner corporation; (2) petitioner's covenant to pay the Water Co. and the Fontana Co. the difference between the value of the 100 shares and the value of the properties so to be conveyed as soon as the value and the method of payment could be agreed upon between the three corporations

and approved by the commission; and, (3) the further covenant of petitioner that, pending the fixing of the value and making of payment, the petitioner, from time to time, would pay over to the Water Co. and the Fontana Co. [7] all its earnings remaining after paying or providing for payment of its operating expenses, taxes, and interest and all obligations it might have incurred or for which it might have become responsible.

Thereafter, on October 10, 1916, the Railroad Commission of California made and rendered its decision granting petitioner authority to issue the 100 shares of capital stock of the par value of \$100 per share as part payment to the Water Co. and the Fontana Co. for a powerhouse site and certain property rights and to issue the \$350,000 of its first mortgage 6 percent bonds upon certain conditions, and granting authority to petitioner to enter into the proposed contract with the Water Co. and the Fontana Co. on the proposed terms, conditioned upon the approval by the commission of a copy of the contract to be thereafter filed by petitioner. The commission also declared that public convenience and necessity required the construction by petitioner of the proposed hydroelectric power plant and system.

Thereafter, on January 30, 1917, the Railroad Commission of California issued a supplemental order approving the mortgage and trust deed, which approval was the condition precedent to the issuance of the mortgage bonds. The supplemental order

recited that the \$350,000 6 percent mortgage bonds were to be secured by a mortgage upon all the property then owned or thereafter to be acquired by petitioner.

On February 6, 1917, the Railroad Commission of California issued a second supplemental order, re-approving the mortgage and trust deed in slightly amended forms. Thereafter, on June 6, 1917, the commission, by its third supplemental order, authorized petitioner to enter into a contract with the Water Co. and the Fontana Co. substantially in the form of the contract as filed with the commission on February 23, 1917, which contract has heretofore been set out in substance.

Thereafter, on June 15, 1917, petitioner entered into the contract with the Water Co. and the Fontana Co. and the latter two corporations conveyed the properties and rights to the petitioner. Pursuant to the commission's order petitioner also executed the trust indenture, and bonds of petitioner in the amount of \$350,000 were issued and sold under the indenture, and the proceeds were used in the development of petitioner's property. The properties and rights acquired from the Water Co. and the Fontana Co. were leased by petitioner to the Southern California Edison Co. for 30 years, commencing July 1, 1917, and were mortgaged by petitioner under the trust indenture to secure its bond issue.

When petitioner was incorporated, 5 qualifying shares were issued. Thereafter, pursuant to the commission's order authorizing the contractual agree-

ment with the Water Co. and the Fontana Co., petitioner issued to the Fontana Co. 50 shares of stock and a like number [8] to the Water Co. In 1927 the Water Co. acquired the 50 shares originally issued to the Fontana Co., and also acquired all interests and rights originally acquired and owned by the Fontana Co. under the agreement; and at all times since the Water Co. has been, and still is, the owner of the 100 shares of stock and of all rights originally acquired by the Fontana Co. and the Water Co. in and under the agreement. These 105 shares of stock are the only shares of petitioner corporation which have ever been issued.

During the year 1937 the Water Co. and the petitioner executed an agreement for the purpose of construing and resolving the meaning of certain provisions of the original agreement. By this 1937 agreement petitioner was allowed to deduct from its gross income, when calculating net income for the purposes of the original agreement, all charges for discount of its outstanding bonds and any expense in connection therewith. By order of October 25, 1937, the Railroad Commission of California approved this interpretation of the agreement.

During the year 1917, petitioner constructed the proposed hydroelectric plant on the powerhouse site, and also constructed pipe lines along the right of way conveyed to it by the Water Co. and the Fontana Co. Aside from income arising out of its business, petitioner never acquired any property of substantial value other than that conveyed to it by the deeds from the Water Co. and the Fontana Co., and

the improvements acquired with the proceeds from the sale of the bonds.

Commencing July 1, 1917, and at all times since its construction, the plant has been operated by the Edison Co. under the lease whereby petitioner reserved and receives electricity generated in said plant for supplying its customers, and the Edison Co. pays a rental determined by and based upon the excess power generated in the hydroelectric plant. At all times since the plant's erection the only business of petitioner has consisted of supplying its customers in the Fontana territory with electric power, either generated at its plant, or, in the case of a deficiency for its requirements, purchased and received by petitioner from the Edison Co.

The amounts claimed by petitioner as deductions from gross income, which amounts were disallowed by respondent (being \$18,262.39, \$16,244.55, and \$27,000 for the years 1935, 1936, and 1937, respectively), were paid by petitioner to Water Co. pursuant to that provision of the agreement between the corporations calling for the payment of all annual net income.

[The value of the properties and rights conveyed to petitioner by the Water Co. and the Fontana Co. has not yet been fixed, and the method of payment of the remainder of the purchase price thereof has not yet been determined, and, since the commencement of petitioner's operations in 1917, all of its net income in excess of operating and other expenses and an 8 percent dividend on its outstand-

ing capital stock has been paid to the Water Co. and the Fontana Co., pursuant to the agreement between the three corporations.]

No orders have been issued by the Railroad Commission of California bearing on the valuation of the properties conveyed to petitioner or bearing on the agreement between the three corporations or the lease to the Southrn California Edison Co. or the trust indenture or the bonds issued thereunder other than the orders mentioned above.

No attempt has at any time been made by petitioner to fix the value of the properties conveyed to it or to secure the approval of the Railroad Commission of California to the fixing of that value other than the mention of the value of \$349,500 in the amended application of petitioner to the commission in October 1916. Petitioner has never made any of the payments provided for in the agreement other than to issue the 100 shares of stock and the payments of income, as per agreement, as set out above.

In its annual reports to the Railroad Commission of California and in its Federal tax returns from 1917 to date, petitioner has deducted from its gross income the payments made by it pursuant to the agreement with the Water Co. and the Fontana Co.

OPINION.

Kern: In the original petition filed with this Board the taxpayer claimed that the amounts paid to the Water Co. under the agreement were de-

ductible as "rentals or other payments" within the meaning of section 23 (a) of the Revenue Acts of 1934 and 1936. Petitioner has apparently abandoned that theory, and properly so, inasmuch as title to the properties conveyed was passed to the taxpayer, whereas section 23 (a) applies only to properties to which the taxpayer has not or is not taking title or in which he has no equity. Petitioner, however, does assert that the payments to the Water Co. should be considered as analogous to the payments of Maryland and Pennsylvania ground rents, which, if the ground rent is irredeemable, should be deductible to the extent they constitute a proper business expense pursuant to the general language of section 23 (a) and without regard to the specific clause having to do with rentals. This ingenious argument is without validity. The contract does not call for the payment of ground rents. It provides for a method by which a purchase price for the property granted to petitioner may at some future time be determined if the parties should choose to do so, and, pending such determination, provides for payment to the grantors, who held all of petitioner's stock (with the exception of qualifying shares), of all of petitioner's net earnings. We are not disposed to construe such a [10] contract, executed in California by California corporations and having as its subject matter California real estate, in a way which introduces into that commonwealth the feudal relics of real property law which have happened to survive because of historical reasons

in the two states of Pennsylvania and Maryland. We are equally unwilling to draw analogies in any interpretation of the revenue laws from "distinctions spun out of the tenuosities of surviving feudal law", to use of phrase of Mr. Justice Frankfurter in his opinion in *Helvering v. Hallock*, 309 U. S. 106.

By amendment to his original petition, the taxpayer now makes the further claim that the amounts in controversy are deductible as interest payments by virtue of section 23 (b). It appears from the stipulation filed in this proceeding that the Water Co. has been held by the Bureau of Internal Revenue to be exempt under section 101 of the Revenue Acts of 1934 and 1936 from income and capital stock taxation, but petitioner has not claimed exemption under section 101 (14); nor could such a claim be sustained had it been advanced. The issue before us is whether the disputed payments must be called interest payments or distribution of profits in the nature of dividends.

Both parties to this proceeding have cited numerous cases in their briefs in support of their respective contentions. The cited cases do not lay down any comprehensive rule which may be applied in all cases; and in each proceeding of this nature it must be determined on the facts presented whether the real transaction was that of an investment in the corporation or a loan to it. *Proctor Shop, Inc.*, 30 B. T. A. 721; affd., 82 Fed. (2d) 792. On this question the designation of the instrument and the terms

therein incorporated, while not to be ignored, are not conclusive. *I. Unterberg & Co.*, 2 B. T. A. 274. The real intent of the parties is to be ferreted out and for this latter purpose evidence *aliunde* the contract is admissible. *Proctor Shop, Inc.*, *supra*. In a majority of the cases of this nature which have come before this Board the instrument issued by the corporation has been some form of stock certificate. In the instant proceeding the provision for payment of petitioner's earnings to the Water Co. is not found on the capital stock certificates, but in the same agreement under which petitioner issued the 100 shares of capital stock to the Water Co.

The Water Co. advanced properties and property rights to the petitioner. It was not money which was advanced, but assets which had a monetary value. Had the Water Co. wanted to treat the transaction merely as a loan, with a definite annual income, in the nature of interest, from the transaction, it could have demanded a certain fixed payment from the petitioner each year until a certain fixed date, when the principal should become unconditionally due. The value of the properties transferred was, however, not agreed upon at the time of the transaction.

[11]

Let us look at petitioner's condition at the time of the transaction. It had a charter and an option to purchase certain piping, but these appear to have been its sole assets. It was desirous of securing a franchise and for this purpose needed the assets which the Water Co. transferred pursuant to the

agreement in question. It, in turn, borrowed from the bank in order to purchase and erect the building, pipe lines, etc., on the properties, and, in exchange for this loan, issued \$350,000 worth of 6 percent first mortgage bonds. The bonds were specifically secured by all the interest of petitioner in and to any of its properties held at that time, or property interests to be acquired in the future, including the benefits to be received from a 30-year lease which petitioner made with the Edison Co., under which all its properties were turned over for that term to the Edison Co.

The basic transaction was the one between the Fontana Co. and Water Co. and petitioner. Unless petitioner could have acquired some assets to start with, it would not have been able to carry out either of the other two transactions. The president and treasurer of the Water Co. and the Fontana Co. had become the president and treasurer of petitioner. To say that all three corporations were on friendly terms would be a gross understatement. The central management thought of the newly formed corporation merely as another source of profit. By the issuance of the 100 shares of capital stock (the entire issue except for the qualifying shares), the other two corporations secured control over petitioner's profits and were assured of an 8 percent annual dividend on the stock. No amount equivalent to the value of the properties transferred could have been paid in cash by petitioner at that time, inasmuch as it had neither cash nor unpledged assets;

nor could it ever be paid in the future if the Water Co. held petitioner to the terms of the agreement, because so long as the annual net income had to be paid over to the Water Co. the petitioner never could amass cash or free assets with which to repay the Water Co. at any time for the properties transferred. If there were no profits in any year, then the Water Co. and the Fontana Co. would get nothing. If the profits were enormous, then the Water Co. and the Fontana Co. would get them all. The Water Co. chose to gamble. The mere fact that the aggregate net income paid over to the Water Co. approximates in amount legal interest on the unpaid balance of a loan estimated at \$350,000 is merely coincidental. The transaction was strictly an investment from 1916 up to and including the taxable years.

As we said in *Bakers' Mutual Cooperative Association of Newark, New Jersey*, 40 B. T. A. 656; affd., —— Fed. ——, C. C. A., 3d Cir., Jan. 7, 1941:

* * * a creditor is one who has loaned money or its equivalent to his debtor, the contract giving the creditor not only the unconditional right to demand payment of the principal sum at a definite maturity date, but usually, also, the right to demand, and receive, compensation for its use or retention, i. e., interest. A stockholder, on the other hand, is one who risks his money in an enterprise, participates in its profits and management, shares its losses, and is entitled to receive an aliquot portion of its

assets in the event of liquidation. Northern Fire Apparatus Co., 11 B. T. A. 355; Elko Lamoille Power Co., 21 B. T. A. 291; affd., 50 Fed. (2d) 595.

It may be true that the agreement of 1916 indicated a possibility of the creation of a debtor-creditor relationship and the method to be followed if such a relationship were to be created in the future, but the mere existence of this possibility, which was never fulfilled, can not affect our conclusion that, in reality, during the years in question the relationship of the Water Co. to petitioner was that of an investor and not that of a creditor.

Certain other factors lend further weight to this conclusion. From the facts it appears that in all the years from 1917 until the present time there was no attempt made to agree on a valuation of the properties and thus carry out that clause of the agreement and the order of the Railroad Commission of California which provided for payment of principal. We must assume that the reason for this was that, since the Water Co. during the years in question was the sole stockholder, that company and the petitioner were satisfied with an arrangement whereby all the profits went to the Water Co. under the agreement, and were not interested in creating any debtor-creditor relationship.

That part of petitioner's argument to the effect that the annual payments by petitioner were payments of interest which is based upon a supposed analogy to Pennsylvania and Maryland ground rents

is no more convincing than its argument based on the same analogy to the effect that these payments were ordinary and necessary business expenses, the fallacy of which we have already discussed.

Neither are we impressed by petitioner's argument that the payments involved here, made by petitioner to its stockholders for so many years, can not be considered as distributions in the nature of dividends because (1) they were made pursuant to a contract and not pursuant to the rights of the payees as stockholders, and (2) the distributions consisted of the net earnings and not the surplus profits technically available for dividends. We are persuaded that the contract was executed and the distributions were made for so many years pursuant thereto because the Fontana Co. and/or the Water Co. were the holders of all of the stock of petitioner (except qualifying shares). It was because of this latter fact that the arrangement proved so permanently satisfactory to petitioner's controlling stockholders, and if we are to recognize the realities we must conclude that the ultimate reason for the distributions made to the Fontana Co. and/or the [13] Water Co. was because, for all practical purposes, they were the sole stockholders of petitioner. As to them, by the peculiar arrangement present in this proceeding, it made little difference whether the distribution consisted of petitioner's net earnings or surplus profits. By the contract which they imposed on their wholly owned subsidiary they were entitled to the former. Without the contract they would have been entitled

to the latter. The amount to be received by them would be the same. The practical effect of the transactions was to distribute an amount equivalent to the net profits of petitioner to its stockholders.

We conclude that the payments made by petitioner to the Water Co. according to the agreement in the taxable years were distributions in the nature of dividends, and, accordingly, were not payments of interest, or ordinary and necessary business expenses.

Decision will be entered for the respondent. [14]

EXHIBIT 1A

United States Board of Tax Appeals
Washington

Docket No. 99767

FONTANA POWER COMPANY,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

DECISION

Pursuant to the determination of the Board, as set forth in its Findings of Fact and Opinion, promulgated March 21, 1941, it is

Ordered and Decided: That there are deficiencies in income tax for the years 1935, 1936 and 1937 in the respective amounts of \$2,536.66, \$1,758.22, and

\$3,130.50, and deficiencies in excess profits tax for said years in the respective amounts of \$922.42, \$189.87 and \$2,787.58.

Enter:

Entered March 29, 1941.

(Board of Tax Appeals)

(U. S. 1924)

(Seal)

JOHN W. KERN,

Member [15]

EXHIBIT 2

United States Circuit Court of Appeals
For the Ninth Circuit

[Title of Cause.]

PETITION FOR REVIEW OF DECISION OF THE BOARD OF TAX APPEALS

To the Honorable Judges of the United States Circuit Court of Appeals for the Ninth Circuit:

The petition of Fontana Power Company, a corporation organized under the laws of the State of California, and having its principal office at Fontana, California, respectfully shows:

1. This is a proceeding for review by the United States Circuit Court of Appeals for the Ninth Circuit, of a decision of the United States Board of Tax Appeals, entered on March 29, 1941, redetermining deficiencies in income taxes and excess profits taxes of petitioner for the taxable years of 1935, 1936 and 1937, in the aggregate amount of

\$11,325.25, of which amount \$11,294.07 was in dispute. [16]

2. Petitioner filed income tax returns for said years of 1935, 1936 and 1937 with the Collector of Internal Revenue of Los Angeles, California. The office of said Collector is within the Ninth Circuit.

3. The nature of the controversy before the Board of Tax Appeals was the determination of income and excess profits taxes of petitioner for the years of 1935, 1936 and 1937, and in particular whether certain payments made by petitioner during each of said years, pursuant to or under a contract made by petitioner, were deductible from gross income in the determination of net taxable income.

Petitioner contended before said Board of Tax Appeals, and now contends, that said payments were deductible from petitioner's gross income.

(a) as interest, pursuant to the provisions of section 23 (b) of the Internal Revenue Code; and,

(b) as ordinary and necessary expenses of petitioner's business, pursuant to the provisions of Section 23 (a) of said Internal Revenue Code.

Said Board of Tax Appeals held that said payments were in the nature of dividends or distributions of income, and were not deductible from petitioner's gross income.

Wherefore, your petitioner prays this Honorable Court to review the action of the Board of Tax Appeals in this cause and reverse the decision of said Board and direct [17] the entry of the decision

of said Board in favor of petitioner, determining that said payments are allowable deductions and determining petitioner's tax liability accordingly.

GEO. W. HELLYER

JOHN B. SURR

Attorneys for Petitioner,

204 Citizens National Bank Bldg.,
San Bernardino, California.

State of California,

County of San Bernardino.—ss.

J. D. McGregor, being first duly sworn, says: that he is an officer, to wit, the Secretary of Fontana Power Company, the petitioner named in and that makes the above and foregoing petition; that he has read said petition and knows the contents thereof and that the same is true of his own knowledge, except as to the matters therein alleged upon information or belief, and as to such, he believes it to be true.

J. D. McGREGOR

Subscribed and sworn to before me this 16th day of June, 1941.

(Notarial Seal)

P. McLARNAN,
Notary Public in and for said
County and State.

[Endorsed]: U. S. B. T. A. Filed July 10, 1941.

[18]

EXHIBIT 3

(SUPPLEMENTAL APPLICATION TO
RAILROAD COMMISSION)

To the Honorable the Railroad Commission of the State of California.

This Amendment to Application of Fontana Power Company, Fontana Union Water Company and Fontana Company respectfully shows:

I.

In the above entitled Application, heretofore filed with the Railroad Commission, Fontana Power Company, Fontana Union Water Company and Fontana Company submitted for the approval of the Railroad Commission the proposed purchase by Fontana Power Company from Fontana Union Water Company and Fontana Company of a power house site, rights of way and rights to use certain waters of Lytle Creek in San Bernardino County, California, for the total consideration of three hundred and forty-nine thousand, five hundred dollars (\$349,500), to be paid by Fontana Power Company to Fontana Union Water Company and Fontana Company, the description of the property so to be purchased and the terms of payment therefor being set forth in full in a copy of a certain option agreement attached to said Application and marked "Exhibit C" and made a part thereof.

II.

It now appears impossible to prepare and submit to the Railroad Commission, at the present time,

data sufficient to enable the Railroad Commission to fix the value and approve the [19] purchase price of said properties so proposed to be conveyed by Fontana Union Water Company and Fontana Company to Fontana Power Company.

III.

Fontana Power Company has acquired an option until October 6th, 1916, for the purchase of such steel required for the pressure pipe forming part of the hydro-electric system proposed to be constructed by Fontana Power Company, as set forth in the above-entitled Application, and if said option is not exercised on or before October 6th, 1916, the cost of such steel will be greatly increased.

IV.

Fontana Power Company, Fontana Union Water Company and Fontana Company, in order to prevent the loss of such valuable steel contract, and to provide further time within which data may be furnished to and considered by the Railroad Commission for the fixing of the value and approval of the purchase price of the properties so to be conveyed by Fontana Union Water Company and Fontana Company to Fontana Power Company, now propose, subject to the approval of the Railroad Commission, to enter into an agreement in such form as the Railroad Commission hereafter shall approve, providing for the immediate conveyance by Fontana Union Water Company and Fontana Company to Fontana Power Company of all

the properties described in said option agreement, for the consideration of (a) one hundred (100) shares of the capital stock of Fontana Power Company, to be issued and delivered to Fontana Union Water Company and Fontana Company, or their nominees, upon the execution and delivery by them of a proper conveyance or con- [20] veyances of said property, (b) the covenant of Fontana Power Company to pay to Fontana Union Water Company and Fontana Company the difference between the value of said shares and the value of the properties so to be conveyed as soon as the value of said properties and the method of payment therefor can be agreed upon between Fontana Union Water Company, Fontana Company and Fontana Power Company and approved by the Railroad Commission, or in such other manner as may be required by law, and (c) the further covenant of Fontana Power Company that, pending the fixing of said value and the making of payment therefor, Fontana Power Company, from time to time, will pay over to Fontana Union Water Company and Fontana Company all its earnings remaining after paying or providing for payment of its operating expenses (including depreciation), taxes and interest and all obligations it may have incurred or for which it may have become responsible, and, in the event of sale of all or any portion of its properties, it will pay over to Fontana Union Water Company and Fontana Company the entire proceeds remaining from such sale, after paying or providing for the pay-

ments of its indebtedness and all expenses and obligations it may have incurred or for which in any way it may have become responsible.

Wherefore, Fontana Power Company, Fontana Union Water Company and Fontana Company pray for the following relief:

(a) For permission for Fontana Power Company to issue to Fontana Union Water Company and Fontana Company one hundred (100) shares of the capital stock of Fontana Power Company as part payment for the properties above described.

[21]

(b) For permission for Fontana Power Company to execute with Fontana Union Water Company and Fontana Company an agreement for the payment of the remainder of the purchase price of said properties when the value thereof can be determined in the manner above set forth and for the payment in the meantime of the surplus earnings of said properties and the net proceeds of any sale thereof, all as above described.

(Duly verified.) [22]

EXHIBIT 4.

(Excerpts from Decision No. 3773 of Railroad Commission of California, Dated October 10, 1916)

“ . . . In addition, Fontana Power Company proposed to issue 100 shares of its stock of the par value of \$100 per share to Fontana Union Water

Company and Fontana Company as part payment for a power house site, rights of way and rights to use certain waters of Lytle Creek, in San Bernardino County.

The transaction involving the transfer of these properties by Fontana Union Water Company and Fontana Company to Fontana Power Company will be covered by an agreement, under the terms of which Fontana Power Company will deliver the \$10,000, par value of stock, and will further covenant:

1. To pay to Fontana Union Water Company and Fontana Company the difference, if any, between the value of said \$10,000 of stock and the value of the properties so to be conveyed, as soon as the value of the said properties and the method of payment therefor can be agreed upon between the parties and approved by the Railroad Commission.

2. To pay to Fontana Union Water Company and Fontana Company, pending the fixing of the value of the properties conveyed, all its profits from the business after meeting all necessary charges; and in case of sale, the proceeds remaining after paying its obligations.

This arrangement has been entered into because no definite value has at this time been fixed for the properties to be transferred to Fontana Power Company and request is made to issue \$10,000 of par value stock in the form of first payment."

"It is hereby ordered that Fontana Power Company be granted authority, and it is hereby granted authority, to issue one hundred (100) shares of its capital stock of the par value of One Hundred Dollars (\$100) per share to Fontana Union Water Company and Fontana Company as part payment for a power house site, rights of way and rights to use certain waters of Lytle Creek, in San Bernardino County;" [23]

* * * * *

"It is further ordered that Fontana Power Company be granted authority to enter into a contract with Fontana Union Water Company and Fontana Company, under the terms of which Fontana Union Water Company and Fontana Company shall convey to Fontana Power Company, a power house site, rights of way and rights to use certain waters of Lytle Creek, in San Bernardino County, for the following consideration:

(a) One hundred (100) shares of the capital stock of Fontana Power Company, to be issued and delivered to Fontana Union Water Company and Fontana Company, or their nominees, upon the execution and delivery by them of a proper conveyance or conveyances of said properties, (b) the covenant of Fontana Power Company to pay to Fontana Union Water Company and Fontana Company the difference between the value of said shares and the value of said properties and the method of payment

therefor can be agreed upon between Fontana Union Water Company, Fontana Company and Fontana Power Company and approved by the Railroad Commission, or in such other manner as may be required by law, and, (c) the further covenant of Fontana Power Company to pay to Fontana Union Water Company and Fontana Company, pending the fixing of the value of the properties conveyed, all its profits from the business after meeting all necessary charges; and in case of sale, the proceeds remaining after paying its obligations; provision to be made for the prior rights attaching to the ownership of stock of Fontana Power Company.

The authority to enter into said contract is conditioned upon the approval by the Railroad Commission of a copy of said contract to be hereafter filed by Fontana Power Company.” [24]

EXHIBIT 5

This agreement, made this 30 day of January, 1917, between Fontana Company and Fontana Union Water Company, both corporations organized and existing under the laws of the State of California, parties of the first part, and Fontana Power Company, a Corporation organized and existing under the laws of the State of California, party of the second part.

Witnesseth:

Whereas, the party of the second part desires to acquire from the party of the first part certain valuable properties, easements and rights respectively described in the drafts of two indentures hereunto attached and respectively marked Exhibit "A" and Exhibit "B" and

Whereas, it is not possible at this time to fix the definite value of the properties, easements and rights so to be acquired by the party of the second part from the parties of the first part, and to secure the approval of such value by the Railroad Commission of the State of California; and

Whereas, it is necessary that construction be begun immediately upon the power plant and hydro-electric system proposed to be constructed by the party of the second part upon the real property forming part of the property so to be acquired by the party of the second part; and

Whereas, the purchase by the party of the second part from the parties of the first part of the properties, easements and rights described in said two indentures hereunto annexed and the form of this agreement have been approved by the Railroad Commission of the State of California, in its decision No. 3773, made and [25] entered on the 10th day of October, 1916;

Now, therefore, in consideration of the mutual covenants hereinafter expressed, the parties hereto do agree as follows:

First: The parties of the first part agree forthwith to execute, acknowledge and deliver unto the party of the second part two indentures substantially in the form of the drafts of indentures hereunto annexed and respectively marked Exhibit "A" and Exhibit "B" conveying and assigning to the party of the second part all the properties, easements and rights in such indentures described.

Second: The party of the second part, upon the execution and delivery to it by the parties of the first part of such indentures, and as part consideration for the properties, rights and easements thereby conveyed, agrees to [issue to said Fontana Company a certificate of stock representing fifty (50) fully paid shares of the capital stock of said party of the second part, and to issue and deliver to said Fontana Union Water Company a certificate representing fifty (50) fully paid shares of the capital stock of the party of the second part.]

Third: The party of the second part further agrees to [pay to said Fontana Company and Fontana Union Water Company, one-half to each, the difference between the value of said one hundred (100) shares of the Capital Stock of the party of the second part and the value of the properties so to be conveyed by the parties of the first part to the party of the second part, as soon as the value of said properties and the method of payment therefore can be agreed upon between the parties of the first part and the party of the second part, and approved by the Railroad Commission of the [26]

State of California, or fixed in some other manner in accordance with law.]

Fourth: The party of the second part further agrees, pending the fixing of the value of the properties so to be conveyed, and the payment of the remainder of the purchase price thereof, as aforesaid, to pay to said Fontana Company and Fontana Union Water Company, one-half to each, all profits realized from the business of the party of the second part after paying all its operating expenses (including depreciation), taxes, interest, all obligations which it may incur or for which it may become responsible, and dividends of not exceeding eight per cent (8%) per annum, upon its outstanding capital stock.]

Fifth: The party of the second part further agrees that in the event that its properties, easements or rights are sold before the value of the properties, easements and rights acquired by it from the parties of the first part has been fixed and paid as aforesaid, the party of the second part will pay to said Fontana Company and Fontana Union Water Company, one-half to each, the entire proceeds of such sale or sales remaining after paying or providing for the payment of the indebtedness, expenses and all obligations of the party of the second part and setting aside for the benefit of its stockholders an amount equal to the par value of its outstanding capital stock.

In witness whereof, the parties hereto, on the day and year first above written, have hereunto

caused their corporate names to be subscribed and their corporate seals to be affixed by [27] their respective officers thereunto duly authorized by resolution duly and regularly adopted by their respective Boards of Directors.

FONTANA COMPANY,

By A. B. MILLER,
President

By RAY H. BASSLER,
Secretary

FONTANA UNION WATER
COMPANY,

By A. B. MILLER,
President

By RAY H. BASSLER,
Secretary

FONTANA POWER COMPANY,

By A. B. MILLER,
President

By RAY H. BASSLER,
Secretary. [28]

EXHIBIT 6

Decision No. 4376.

Before the Railroad Commission of the
State of California

Application No. 2245.

In the Matter of the Application of FONTANA POWER COMPANY for a certificate of public convenience and necessity, for permission to issue stock and bonds and to mortgage property to secure said bonds, and for permission to enter into a certain indenture of lease.

In the Matter of the Application of SOUTHERN CALIFORNIA EDISON COMPANY, a corporation, for authority to enter into a certain indenture of lease and to enter into a certain contract for the sale of power.

In the Matter of the Application of RIALTO DOMESTIC WATER COMPANY, a corporation, to enter into a certain contract for the purchase of power.

By the Commission.

Third Supplemental Order

Whereas this Commission in Decision Number 3773, dated October 10, 1916, authorized Fontana Power Company and Southern California Edison Company to enter into a contract for lease of property and purchase and sale of electric power, in the form of a [29] copy of said contract filed with this Commission as Exhibit "1"; and

Whereas this Commission further authorized Fontana Power Company to enter into a contract with Fontana Union Water Company and Fontana Company for the transfer of certain property, said authority being conditioned upon the approval of a copy of said contract by this Commission; and

Whereas Fontana Power Company has now advised this Commission that the contract between Fontana Power Company and Southern California Edison Company, as finally executed differed in certain minor particulars from the form of contract approved by this Commission in Decision Number 3773, and has filed for the Commission's approval a copy of said contract as finally executed; and

Whereas Fontana Power Company has also filed for this Commission's approval a copy of the proposed contract to be entered into between Fontana Power Company, Fontana Union Water Company and Fontana Company, covering the transfer of certain property;

And it appearing to this Commission that the contract between Southern California Edison Company and Fontana Power Company should be approved and that Fontana Power Company should be authorized to enter into a contract with Fontana Union Water Company and Fontana Company, covering the transfer of certain property;

It is hereby ordered that the contract dated January 18, 1917, between Fontana Power Company and Southern California Edison Company be and the same is hereby approved, a copy of said contract

being on file herein, marked "Exhibit 1 amended".

[30]

The approval of the contract between Fontana Power Company and Southern California Edison Company is given on the condition that the Railroad Commission reserves the right hereafter to issue such orders as it may find necessary, which may modify or affect the terms of the lease set forth in said contract, or the terms and conditions of the interchange of electric power as set forth in said contract.

It is hereby further ordered that Fontana Power Company be and it is hereby authorized to enter into a contract with Fontana Company and Fontana Union Water Company substantially in the form of a contract filed with this Commission on February 23, 1917, and marked Exhibit "11";

The approval herein given of said contracts is for the purpose of this proceeding only and is an approval only in so far as this Commission has jurisdiction under the terms of the Public Utilities Act, and is not intended as an approval of said contracts as to such other legal requirements to which said contracts may be subject.

Dated at San Francisco, California, this 6th day of June, 1917.

MAX THELEN
H. D. LOVELAND
ALEX GORDON
EDWIN O. EDGERTON
Commissioners.

[Endorsed]: U.S.B.T.A. Filed Aug. 5, 1941. [31]

United States Board of Tax Appeals
Washington

Docket No. 99767

FONTANA POWER COMPANY,

Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

CERTIFICATE

I, B. D. Gamble, Clerk of the U. S. Board of Tax Appeals, do hereby certify that the foregoing pages 1 to 31, inclusive, contain the record on appeal as agreed to by the parties in accordance with Rule 76 of the Rules of Civil Procedure for the District Courts of the United States.

In testimony whereof, I hereunto set my hand and affix the seal of the United States Board of Tax Appeals, at Washington, in the District of Columbia, this 12th day of August, 1941.

(Seal) B. D. GAMBLE,
Clerk, United States Board of Tax Appeals.

[Endorsed]: No. 9901. United States Circuit Court of Appeals for the Ninth Circuit. Fontana Power Company, a corporation, Petitioner, vs. Commissioner of Internal Revenue, Respondent. Transcript of the Record. Upon Petition to Review a Decision of the United States Board of Tax Appeals.

Filed August 27, 1941.

PAUL P. O'BRIEN,
Clerk of the United States Circuit Court of Appeals
for the Ninth Circuit.

In the United States Circuit Court of Appeals
For the Ninth Circuit

No. 9901

FONTANA POWER COMPANY,

Appellant.

vs.

COMMISSIONER OF INTERNAL REVENUE,
Appellee.

STATEMENT OF POINTS RELIED UPON BY
APPELLANT ON APPEAL AND DESIG-
NATION OF PARTS OF RECORD NECES-
SARY.

On appeal to the United States Circuit Court of Appeals for the Ninth Circuit, from a decision of the United States Board of Tax Appeals (herein-

after called "Board"), entered March 29, 1941, appellant, Fontana Power Company, intends to rely, and relies, on the following points:

1. Said decision is contrary to law in that thereby income taxes and excess profits taxes for the years 1935, 1936, and 1937, are imposed upon amounts in excess of appellant's net taxable income for said years, respectively, such excessive amounts corresponding with and being equal to payments made by appellant to Fontana Union Water Company, as follows:

For 1935, the sum of \$18,262.39;

For 1936, the sum of \$16,244.55;

For 1937, the sum of \$27,000.00.

2. Said Board erred in holding that said payments of \$18,262.39, \$16,244.55 and \$27,000.00 were not deductible from appellant's gross income for the respective years paid.

3. Said Board erred in holding said payments were distributions in the nature of dividends.

4. Said Board erred in holding said payments were not interest.

5. Said Board erred in holding said payments were not ordinary and necessary business expenses.

DESIGNATION OF PARTS OF RECORD

Appellant hereby designates as necessary for consideration of the points relied upon, the entire transcript as certified by the Clerk of the Board and filed with the Clerk of the above named Court. The Clerk of the above named Court is requested and

directed to cause said transcript to be printed in its entirety.

Dated: September 2, 1941.

GEO. W. HELLYER,

JOHN B. SURR,

Counsel for Appellant.

AFFIDAVIT OF SERVICE BY MAIL

State of California

County of San Bernardino—ss.

P. McLarnan, being first duly sworn, says:

I am a citizen of the United States of America, over the age of eighteen years, a resident of the above named County and State, and not a party to the action named in the title of the annexed document. My business address is Suite 204 Citizens National Bank Building, San Bernardino, California.

On the date of mailing shown below I deposited in the United States mail at San Bernardino, California, at the request of Surr & Hellyer, a sealed envelope (postage prepaid) which contained a true copy of each annexed document, and which envelope was addressed to the office address of the addressee, as follows:

Date of mailing:—September 2, 1941

Document mailed:—Statement of Points and Designation of Record.

Name and address:—J. P. Wenchel, Esq., Chief Counsel, Bureau of Internal Revenue, Washington, D. C.; attention R. L. Williams, Esq.

At the time of said mailing there was regular communication by mail between the place of mailing and the place so addressed.

P. McLARNAN

Subscribed and sworn to before me this 2d day of September, 1941.

(Seal) F. A. LEONARD, JR.,
Notary Public in and for the County of San Bernardino, State of California.

[Endorsed]: Filed Sept. 4, 1941. Paul P. O'Brien,
Clerk.

